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INCOME TAX TREATMENT OF NONREFUNDABLE CAPITAL CONTRIBUTIONS TO FEDERAL NATIONAL MORTGAGE ASSOCIATION

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Mr. BYRD of Virginia, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 7885]

The Committee on Finance, to whom was referred the bill (H.R. 7885) relating to the income tax treatment of nonrefundable capital contributions to Federal National Mortgage Association, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

I. SUMMARY OF BILL

H.R. 7885 deals with the problem of financial institutions which sell mortgage paper to the Federal National Mortgage Association. Such institutions are required to subscribe to the FNMA stock in an amount equal to 2 percent of the mortgages sold. This stock which is issued at a par value of $100 has been selling on the market for appreciably less than the issuance price. The bill, as passed by the House and as reported by your committee, provides that where FNMA stock is purchased under these conditions, any excess of the issuance price over the fair market value is to be treated as an ordinary and necessary business expense in the year of purchase rather than as a cost of acquiring the stock. This treatment is to be available to taxable years beginning after December 31, 1959.

In addition to approving the House bill, your committee has added to the bill a number of amendments to other provisions of the Internal Revenue Code which are as follows:

Section 4 of the bill provides that exemptions may be claimed for dependents who were born in, or are residents of, American Samoa or Swains Island.

Section 5 of the bill provides that for purposes of determining whether the 8-out-of-10-year test has been met with respect to the deduction for nonlimited charitable contributions, two periods of 2 consecutive years may be averaged. To be eligible for this averaging of past years in determining eligibility for this deduction, contributions must be made directly to a church, school or college, hospital, certain medical research organizations, or organizations receiving a substantial portion of their support from governmental units or from the general public.

Section 6 of the bill is designed to prevent a doubling up of deductions for State taxes in the case of accrual basis taxpayers where the doubling up is a result of the action of a taxing jurisdiction taken after December 31, 1960.

Section 7 of the bill provides that producers of minerals used in making cement may, for open years prior to 1961, use as the base for computing percentage depletion (or cutoff point) the gross income which may be derived from the minerals just prior to the introduction of the kiln feed into the kiln.

Section 8 of the bill permits a partnership, or a proprietorship, which has elected to be taxed as a corporation to apply the tax-free reorganization provisions generally applicable to corporations if the business actually becomes a corporation in a taxable year beginning after December 31, 1959. This section also requires that the election of any of these partnerships or proprietorships to be taxed as a corporation be made in the last month of the preceding year or the first month of the year for which the election is made.

Section 9 of the bill amends the manufacturers' tax on mechanical lighters for cigarettes, cigars, and pipes to provide that the tax is to be 10 cents per lighter or 10 percent of the manufacturers' sales price, whichever is the lesser (under present law only the rule relating to the 10 percent of the manufacturers' sales prices is applicable).

Section 10 of the bill is intended to eliminate the filing of 1.7 million nontaxable declarations of estimated tax by (1) increasing the "Other income" limit from $100 to $200, and (2) providing that no declaration need be filed where the estimated tax is less than $40. Also, to simplify filing requirements, the gross income test of $400 plus $600 times the number of exemptions is eliminated.

Section 11 of the bill requires individuals living abroad and other taxpayers (including corporations) claiming the benefit of foreign income provisions to file their returns at the internal revenue office designated by the Secretary rather than in the district where they claim legal residence or place of business.

Section 12 of the bill repeals section 7207 of the code. Thus fraudulent returns, statements or other documents are not to be prosecuted as misdemeanors but rather as felonies. The section also provides that claiming a false or fraudulent deduction for a dependent will be treated as a misdemeanor rather than a felony.

II. NONREFUNDABLE CONTRIBUTIONS TO FEDERAL NATIONAL MORTGAGE ASSOCIATION (SECS. 1, 2, AND 3)

The Federal National Mortgage Association is a mixed-ownership Federal corporation, having on January 1, 1960, preferred stock of $142,820,000 owned by the Federal Government and common stock

of $53,319,200 owned by more than 5,800 different private shareholders. The Association was originally chartered by Congress in 1938 and rechartered in 1954. One of its principal purposes is to supplement the general secondary market for home mortgages. As a result, when a financial institution such as a bank or other mortgage lender or investor desires to obtain more liquid funds, it may sell qualifying mortgages to the Federal National Mortgage Association.

The 1954 act rechartering the Association provided, however, that the Association was to accumulate capital funds by requiring each mortgage seller to make payments of specified amounts of nonrefundable capital contributions to the Association in exchange for capital stock of the Association. Currently, the amount to be paid by a taxpayer-subscriber must equal 2 percent of the unpaid principal of the mortgages he is selling to the Association and for this the Association issues stock on the first day of the succeeding month.

Problems have arisen as to the tax treatment provided for this stock which must be purchased by a taxpayer when he sells mortgage paper to FNMA. The problems have arisen because, although there is a market for the FNMA stock, the market price is appreciably below the stock issuance price, currently the market price being around 55 percent of the issuance price.

Taxpayer-subscribers generally have assumed that any excess of the issuance price over the market price of this stock represented an ordinary and necessary expense incurred in carrying on their trade or business since they acquired the stock in order to sell their excess supply of mortgage paper. In 1958, however, the Internal Revenue Service ruled (Rev. Rul. 58-41, 1958-1 CB 86) that no part of the purchase price of stock of FNMA constituted a deductible business expense. Instead, it was held that the entire amount paid for the stock must be capitalized and treated as the cost of the stock so acquired. Thus, this ruling holds that there is no tax effect at the time of the purchase or issuance of the stock even though the market price of the stock then is substantially below the issuance price. Instead, the tax effect occurs only when the stock is sold by the taxpayer.

Your committee agrees with the House that it is unfortunate to require the capitalization of these expenditures for FNMA stock by taxpayer-subscribers to the extent they represent the excess of purchase price over market price. Viewed from such a taxpayer's standpoint, the excess appears clearly to be expenditures which he must incur in order to sell the mortgage paper he holds. In view of this, the House and your committee believe that such amounts should be treated as ordinary and necessary expenses incurred in carrying on a trade or business. This, of course, means that in the transaction which occurs when the stock is sold (usually a capital transaction) the basis of the stock should not include this amount previously taken as a deduction.

As a result, the first section of this bill adds a new subsection (d) to the section of existing law relating to the deductions of trade or business expenses (sec. 162). The new provision relates to the purchase of FNMA stock where this stock is purchased in order to sell mortgage paper to the Association. In such cases the bill provides that any excess of the issue price of the stock over its fair market value on the date of issue is to be treated as an ordinary and necessary business

expense of that year in carrying on a trade or business. As a result, this excess will be a deduction against ordinary income of the taxpayer for the year the stock is purchased or issued.

Section 2 of the bill provides that the basis of the FNMA stock is to be reduced by the amount required to be deducted against ordinary income under the new provision. As a result, the taxpayer cannot, upon the sale of the stock, receive a tax benefit a second time for the amount previously deducted as an ordinary expense item.

This change is to be effective for taxable years beginning after December 31, 1959. In making this statutory amendment, however, your committee intends no inferences to be drawn as to the tax treatment accorded FNMA stock before the enactment of this provision.

III. DEPENDENCY EXEMPTION FOR CERTAIN INDIVIDUALS BORN IN OR RESIDING IN AMERICAN SAMOA OR SWAINS ISLAND (SEC. 4)

Present law (sec. 152(b)(3)) provides that the term "dependent" includes any individual who is a citizen of the United States, a resident of the United States, of a country contiguous to the United States, or a resident of the Canal Zone, Republic of Panama, and, in certain cases, the Philippines.

Both the 1939 code and the 1954 code contains the same general rule with respect to dependents; namely, that individuals may not be claimed as dependents if they are not citizens or residents of the United States. However, present law defines a "dependent" in terms of one who is a citizen of the United States, while the 1939 code defined a "dependent" in terms of one who is not a citizen or subject of a foreign country. The purpose of expressing the general rule in a positive way in the 1954 code, rather than in the negative way of the 1939 code, was to permit a person who may be a citizen both of the United States and of another country to be treated as any other citizen of the United States.

Unfortunately, this change in the manner of defining a dependent has an additional consequence. It operates to deny a dependency exemption for individuals who are citizens and residents of two U.S. possessions, American Samoa and Swains Island. Section 308 of the Immigration and Nationality Act (8 U.S.C. 1408) provides that such persons are nationals but not citizens of the United States. Under the 1939 code, such persons could qualify as dependents since they were not citizens of a foreign country.

The only cases which have been brought to the attention of the Service relate to certain dependents of U.S. naval personnel residing in American Samoa (and the adjacent Swains Island). The Judge Advocate General's Office of the Navy Department has indicated that less than 100 taxpayers in American Samoa were affected by this change in the 1954 code. However, the exact number of dependents of these taxpayers could not be ascertained. That Office further stated that no other cases had been brought to its attention.

It is not believed that it was intended in the 1954 code to disqualify as dependents these persons who were included in the definition of a "dependent" under the 1939 code.

Accordingly, section 4 of the bill amends the code (sec. 152) to include within the definition of a "dependent" an individual who is

born in or is a resident of American Samoa or Swains Island and who is not a citizen or subject of a foreign country. By including such individuals within the definition of a "dependent," they would be accorded treatment similar to that which they received under the 1939 code.

This amendment applies to taxable years beginning after December 31, 1959.

IV. UNLIMITED DEDUCTION FOR CHARITABLE CONTRIBUTIONS (SEC. 5)

Under present law the charitable contribution deduction of an individual generally is limited to 20 percent of the taxpayer's adjusted gross income, although in the case of contributions to churches, schools and colleges, hospitals, and certain medical research organizations, the limitation is 30 percent instead of 20 percent. However, in addition to this, a deduction for charitable contributions without limitation is allowed where certain conditions are met.

Before an individual is eligible for the unlimited charitable contribution, however, he must establish that he has for an extended period of time given the bulk of his income to charity or has paid it to the Government in the form of taxes. More specifically, to be eligible for the unlimited charitable deduction he must in the current year and in 8 out of the 10 preceding years have given 90 percent of his taxable income to charity or have paid it to the Federal Government in the form of income taxes.

In the Technical Changes Act 1958, Congress provided that in determining whether the 90-percent test was met, income taxes could be attributed to the year in which they were incurred rather than the year in which they were paid. With respect to that change, one of the committee reports indicated it was made because it was believed unfortunate to deny the benefits of the unlimited charitable contribution deductions merely on the grounds of the timing of the income-tax payments.

However, existing law still appears too restrictive in some cases because the timing of charitable contributions results in year-to-year fluctuations in the charitable contributions, even though in 8 out of the last 10 years more than three-fourths of an individual's income went to charitable organizations or for income taxes, and even though in this period the 90-percent test also is met if this test is computed on the basis of the average charitable contributions and income taxes paid in periods of 2 consecutive years.

In view of these considerations your committee has adopted an amendment to section 170(b)(1)(C) to provide an averaging device to meet this problem for the 10-year period ending before January 1, 1961. However, your committee believes that this averaging device should be directed toward encouraging substantial gifts to churches, schools and colleges, hospitals, certain medical research organizations, and other charities, a substantial part of whose support is furnished by a governmental unit or by contributions from the general public. The amendment provides that the averaging device is to be available only if during the current taxable year the 90-percent test is met with respect to a limited category of charitable contributions plus the amount of income taxes paid. The limited category of charitable contributions

are those made to a church, an educational organization, a hospital or certain medical research organizations (described in clause (i), (ii), or (iii) of subsec. (b)(1)(A) of sec. 170), or to an organization receiving a substantial part of its support from a governmental unit or from the general public (that is, an organization described in sec. 503(b)(3)). Where these conditions are met in the current year with respect to which the charitable contribution deduction is being determined, then in determining whether the 90-percent test has been met with respect to 8 out of the 10 prior years, an averaging device may be used. Under these conditions if the sum of the charitable contributions and income taxes paid during any two prior consecutive taxable years each exceed 75 percent of the taxpayer's taxable income for each year, the 90-percent test of existing law will be considered as satisfied with respect to both such years if the sum of the charitable contributions and income taxes paid during the 2 consecutive taxable years exceeds 90 percent of the sum of the combined taxable income for the same 2 years. However, no taxable year shall be included in more than one period of 2 consecutive taxable years and not more than two periods of 2 consecutive taxable years within the 10 preceding taxable years shall be taken into account. As used in this provision, the term "taxable income" means taxable income computed without regard to personal exemptions, charitable contributions, and net operating loss carrybacks.

V. LIMITATION ON ACCELERATION OF ACCRUAL OF STATE TAXES (SEC. 6)

Present law (sec. 164(a)) allows a deduction for "taxes paid or accrued within the taxable year." Under this language, the accrual basis taxpayer is allowed a deduction in the year the taxes accrue regardless of when they are paid. As a general rule, developed through judicial and administrative interpretations, the date of the event which renders the taxpayer unconditionally liable for the tax is considered the proper accrual date. With respect to personal and real property taxes, the accrual date is generally considered either the assessment date, personal liability date, or the lien date, or a combination of these dates. Section 461(c) of the code allows accrual basis taxpayers, at their election, to accrue real property taxes ratably over the period of time to which they relate. Section 461(c) is limited to real property taxes and few taxpayers have elected to accrue those taxes ratably. Therefore, most taxpayers on the accrual basis accrue and deduct taxes in the taxable year in which the accrual date occurs.

Several States have recently enacted legislation which has enabled accrual basis taxpayers to claim that they are entitled to deduct in 1 Federal taxable year property taxes for two full property tax years. The technique employed by the State legislatures to accomplish this is simply to cause the accrual event, such as the assessment date, for 2 years' property taxes, to fall within 1 year. Thus, in a State where real property taxes for the calendar year 1961 were assessed and became a personal liability on January 1, 1961, the State legislature would pass a law changing the assessment and personal liability dates

for 1962 real property taxes from January 1, 1962, to December 31, 1961. In such a case, the accrual-basis calendar year taxpayer might argue that present law permits him to accrue and deduct in the Federal taxable year 1961 the real property taxes assessed for both 1961 and 1962. If the same State continues to assess property taxes for 1963 and all subsequent years on December 31 of the preceding year, the same taxpayer, having claimed the deduction for 2 years' property taxes in 1961, will still claim a deduction for 1 year's taxes in 1962 and for 1 year's taxes in each succeeding year in which taxes are assessed.

This type of State legislation has been widely publicized as being a "tax gimmick." At least one State has specifically provided that for State income tax purposes, the new accrual date shall be disregarded. It is evident that in many cases the primary purpose of such State legislation is to enable accrual basis taxpayers in those States to obtain a Federal income tax benefit.

If the State legislation accomplishes its purpose, a permanent and significant loss of revenue will result and unless remedial legislation is enacted the revenue loss may be significantly increased as other States may well take action similar to that taken by the States mentioned.

To cope with this problem, your committee has included in the bill an amendment which in general would deny an accrual basis taxpayer the right to deduct more than 1 year's State taxes in 1 Federal taxable year. This is done by providing that where the accrual date is earlier than it would be but for any action of any taxing jurisdiction taken after December 31, 1960, such taxes shall be treated as accruing at the time they would have accrued but for such action. This new provision will not apply however, to certain situations where present law properly allows a doubling of deductions, so long as the doubling of deductions is not the result of any action of a taxing jurisdiction.

This section will apply only to taxable years ending after December 31, 1960. Since the section is not retroactive, it is not intended that it apply to taxable years ending prior to January 1, 1961.

VI. ELECTION AS TO BASE FOR DETERMINING PERCENTAGE DEPLETION DEDUCTION IN THE CASE OF MINERALS USED IN MAKING CEMENT (SEC. 7)

A. General Explanation

To determine the percentage depletion allowance under present law, it is necessary to multiply the percentage rate applicable to the particular mineral by the value of the mineral at the point at which the mining process ends. This point is referred to as the "cutoff point." In the case of many mineral industries, this cutoff point has been the subject of uncertainty and litigation. Included in this group is the cement industry.

In 1953 the Treasury Department published a ruling which provided that the cutoff point for taxpayers in the cement industry occurs approximately when the ground material is ready for introduction into the kiln. The ruling was as follows:

SECTION 114.—BASIS FOR DEPRECIATION AND DEPLETION

REGULATIONS 118, SECTION 39.114-1: Basis for allowance of depreciation and depletion. (Also Section 23(m), Section 39.23 (m)-1.) Rev. Rul 290

INTERNAL REVENUE CODE

Determination of the processes properly included in mining under section 114(b)(4)(B) of the Internal Revenue Code, with respect to calcium carbonates and shale mined for use in the manufacture of cement.

Advice is requested concerning the position of the Internal Revenue Service on the determination of the processes properly included in mining with respect to calcium carbonates and shale mined for use in the manufacture of cement.

It is the position of the Internal Revenue Service that calcium carbonates and shale, mined for use in the cement industry, are not customarily sold in the form of the crude mineral product, and that, therefore, under section 39.23 (m)(1)(f) of Regulations 118, crushing and grinding are considered "ordinary treatment processes" in the computation of gross income from the property for percentage depletion purposes. Blending with other material after crushing and grinding, such as that occurring at the kiln feed bins, is excluded from "ordinary treatment processes," but where mixing of the calcium carbonates and shale occurs before or during crushing and grinding, it will be considered as incidental to such processes.

The gross income for percentage depletion purposes must of course be computed separately with respect to each component mineral, notwithstanding any such mixing. The net income for purposes of the limitation on percentage depletion should also be computed separately for each component mineral unless the minerals are produced from the same "property." See Revenue Ruling 76, C.B. 1953-1, 176.

In view of the specific detailed listing in section 114 (b)(4)(A) of the Internal Revenue Code, percentage depletion is not allowable on clay used in the manufacture of cement unless the clay so used definitely comes within one of the specific classifications in that section.

Many cement producers did not accept this cutoff point, but contended that the cutoff point does not occur until finished cement is obtained. This dispute and disputes with producers of other minerals over the cutoff point question resulted in a series of court decisions concluding with the recent Supreme Court case of *U.S.* v. *Cannelton Sewer Pipe Co.* This decision laid down certain guidelines to aid in resolving cutoff point disputes.

In order to resolve the cutoff point question for 1961 and future years, Congress in the Public Debt and Tax Rate Extension Act of 1960 modified a provision of the code (sec. 613(c)). As amended, this statutory provision established specific cutoff points for numerous minerals, including those used in the manufacture of cement. This

cutoff point for cement-producing minerals (except for preheating of the kiln feed) occurs just prior to the introduction of the kiln feed into the kiln. This is derived from the previous ruling of the Treasury Department.

Although the recent legislation determines the cutoff point for the cement industry for future years, it does not settle this question for any open years prior to 1961. It is understood that for these prior years the Government may well contend that under the *Cannelton* decision the cutoff point for the minerals in question occurs at an earlier stage of processing than set forth in the previous ruling. On the other hand, it is understood that certain taxpayers in the cement industry take the position that the principles enunciated in the *Cannelton* case do not apply to them, and that they are entitled to depletion on the basis of finished cement for years prior to 1961. Under such circumstances there is a reluctance to settle cases for the past years on the basis of the published ruling and it is probable that in the absence of this amendment there would be continued and widespread litigation in this area.

Your committee is of the opinion that it is desirable to encourage the settlement of the cutoff point question in the cement industry for the years prior to 1961 on the basis of the cutoff point established by the previous administrative practice of the Treasury Department and adopted by Congress for future years. Extensive litigation in this area would be burdensome both to the Government and to the taxpayers, and also uncertain as to its results. In order to encourage the settlement of this question, section 7 of the bill as amended by your committee permits taxpayers mining minerals used in making cement to elect to apply, for the years prior to 1961, the cutoff point provisions adopted in the Public Debt and Tax Rate Extension Act of 1960. Under this proposal, if a taxpayer failed to make the election, the cutoff point in his case for these years would be determined under existing law.

Under your committee's amendment, any taxpayer in the cement industry who wishes to avoid the continuance of litigation may make the election to accept the established cutoff point for 1960 and earlier years. If a taxpayer makes the election, it will apply to all of his mineral properties used in making cement and to all of his open taxable years before 1961, thus finally establishing the cutoff point in his case. However, the making of the election resolves only the point at which the cutoff occurs and does not deal with any other matters that may be in issue, such as the method of computing the gross income at that point.

Under the bill, the election must be made by the taxpayer on or before 60 days after the date of publication of final regulations on this provision. Once made, the election is irrevocable. The manner of making the election is to be prescribed by Treasury regulations.

B. Technical Explanation

This section, for which there is no corresponding provision in the House bill, amends subsection (c) of section 302 of the Public Debt and Tax Rate Extension Act of 1960 (Public Law 86-564; 74 Stat. 293) relating to the effective date of section 302.

Paragraph (1) of subsection (c) provides that subsections (a) and (b) of section 302 shall be applicable only with respect to taxable years beginning after December 31, 1960, except as provided in paragraph (2) relating to calcium carbonates and other minerals when used in making cement.

Paragraph (2) of subsection (c) provides a special effective date provision for section 302(b) in the case of calcium carbonates and other minerals when used in making cement at the election of any taxpayer mining such minerals. Under subparagraph (A) of paragraph (2), the taxpayer mining minerals used by him in making cement may elect to have the provisions of section 302(b) apply for certain taxable years beginning before January 1, 1960. If a taxpayer makes the election, it applies to all calcium carbonates and other minerals mined and used by him in making cement. The election does not apply to any minerals not used in the manufacture of cement that the taxpayer may also be mining.

If the election is made by the taxpayer, the amendments made by section 302(b) apply to all taxable years subject to the 1954 code for which the election is effective. In addition, provisions having the same effect as the amendments made by section 302(b) are deemed to be included in the 1939 code in lieu of the corresponding provisions of the 1939 code and shall apply to all 1939 code years for which the election is effective. The provisions that are deemed to be included in the 1939 code apply in determining gross income from mining for purposes of sections 450 and 453 of the 1939 code, relating to the excess profits tax.

Subparagraph (B) of paragraph (2) describes the years for which the election is effective. It is effective for all taxable years beginning before January 1, 1961, in respect of which the assessment of any deficiency, or refund or credit of any overpayment, or suit for recovery of a refund under section 7405 of the Internal Revenue Code of 1954, whichever is applicable, is not prevented on the date of the enactment of this section by the operation of any law or rule of law. The election also applies to taxable years beginning before January 1, 1961, in respect of which an assessment of a deficiency has been made but not collected on or before the date of the enactment of this section.

If the application of the election would result in a deficiency for a taxable year beginning before January 1, 1961, but the assessment of the deficiency for such taxable year is prevented on the date of the enactment of this section, then the election would not apply to such taxable year. Similarly, if the election would result in an overpayment for a taxable year beginning before January 1, 1961, but the making of refund or credit is prevented on the date of the enactment of this section, then the election would not apply to such taxable year. Even though an assessment of a deficiency is prevented for a taxable year beginning before January 1, 1961, the election, nevertheless, will apply to such year if a suit for recovery of a refund under section 7405 of the 1954 code could be timely instituted on the date of the enactment of this section. Further, the bill provides that where an assessment of a deficiency has been made for a taxable year beginning before January 1, 1961, but not collected on or before the date of the enactment of this section, the election will apply even though further assessment of a deficiency for such year is prevented on the date of the enactment of this section. Thus, the election will apply to a taxable

year beginning before January 1, 1961, even though further assessment for such year is prevented on the date of the enactment of this section and the election is otherwise inapplicable, where the tax liability for such year is in litigation and the litigation involves a counterclaim for additional tax, the assessment of which was timely made but has not been collected on the date of enactment of this provision.

Subparagraph (C) of paragraph (2) provides that a taxpayer may elect to have the provisions of this paragraph apply, provided he so elects on or before the 60th day after the date of publication in the Federal Register of final regulations issued under authority of subparagraph (F) of this paragraph. The election shall be made in such form and manner as the Secretary of the Treasury or his delegate shall prescribe by regulations. Such election, if made, may not be revoked. If a taxpayer makes an election under this subparagraph he shall be deemed to have consented to the application of section 302(b) and thus subdivision (F) of section 613(c)(4) must be applied in determining gross income from mining for the years to which the election applies. Further, for such years, the term "mining" does not include the phrase "ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products" as that phrase appeared in section 613(c)(2) of the Internal Revenue Code of 1954 as originally enacted or the corresponding provisions of prior law. In applying the election to the years affected, there shall be taken into account the effect that any adjustments to depletion resulting from the election shall have on other items affected thereby, such as charitable contributions, foreign tax credit, net operating loss, and the effect that adjustments to any such items shall have on other taxable years.

Subparagraph (D) of paragraph (2) provides that the period within which the assessment of any deficiency or the credit or refund of any overpayment resulting from the election may be made shall not expire prior to 1 year after the last day on which the election can be made. Thus, if assessment of a deficiency or credit or refund of an overpayment, whichever is applicable, is not prevented on the date of enactment of this section, the time for making the assessment or credit or refund shall not expire for at least 1 year after the last date for making the election, notwithstanding any other provision of law to the contrary. Even though assessment of a deficiency is prevented on the date of enactment of this section, if commencement of a suit for recovery of a refund under section 7405 may be made on such day, then any deficiency resulting from the election may be assessed at any time within 1 year after the last day for making the election. If the taxpayer makes the election, he shall be deemed to have consented to the application of the provisions preventing the expiration of the time for assessing a deficiency attributable to the election. Subparagraph (D) does not shorten the period of limitations otherwise applicable.

Subparagraph (E) of paragraph (2) provides that, unless inconsistent with the purpose and intent of this section, the terms used in this section shall be interpreted as having the same meaning as when used in the Internal Revenue Code of 1954 (or corresponding provisions of prior law) and all provisions of law shall apply with respect to this section as if the section were a part of such code (or corresponding provisions of prior law). Thus, all of the provisions of subtitle F of

the 1954 code and corresponding provisions of prior law shall apply to the extent they can apply, including the provisions of section 6501(c) relating to the extension of the period for assessment by agreement.

Subparagraph (F) of paragraph (2) provides that the Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section. For example, such regulations may include the method and manner of reporting any deficiency attributable to the election, such as the filing of amended returns and the payment of the tax.

VII. SUBCHAPTER R—ELECTION OF CERTAIN PARTNERSHIPS AND PROPRIETORSHIPS TO BE TAXED AS DOMESTIC CORPORATIONS (SEC. 8)

A. General Explanation

1. TIME FOR MAKING THE ELECTION UNDER SECTION 1361

Present law (sec. 1361) gives certain partnerships and proprietorships an election to be taxed as though they were domestic corporations. This election may be made at any time prior to the expiration of 60 days after the end of the first taxable year to which the election is to apply. For example, an eligible partnership or proprietorship wishing to make an election to be taxed as a corporation for the calendar year 1961 could make the appropriate election to do so as late as February 1962.

The retroactive effect of the election has created some difficult problems. For example, the delay in the election has made it difficult for the Government and the taxpayer to determine with sufficient accuracy the assets of the proprietorship or partnership that are considered to have been "transferred" to the enterprise that is to be taxed as a "corporation" and, consequently to be governed by the provisions of section 1361, since the election, once made, is effective from the very beginning of the taxable year for which it is made. Whether particular assets are or are not part of the enterprise taxed as a corporation is important in determining whether there has been a withdrawal of those assets from the enterprise under circumstances giving rise to dividends. Many disagreements on this question have arisen between taxpayers and internal revenue agents.

In addition, it appears questionable whether it is desirable to allow taxpayers to have the benefit of a year's hindsight in determining whether or not to make the election.

Your committee's amendment provides that taxpayers are to be required to make the election under section 1361 within a 2-month period which includes the last month of the preceding taxable year and the first month of the current taxable year for which the election is to be applicable. For example, an eligible partnership or proprietorship wishing to make an election to be taxed as a corporation for the calendar year 1961 would have to make the appropriate election in December 1960, or in January 1961. This is the same period of time in which taxpayers are required to make an election under the new provisions of subchapter S, which allows shareholders of certain corporations to be taxed directly on the income of the corporation.

This amendment would have the effect of making the time period within which the election under subchapters R and S are to be made consistent with one another. An early election would minimize the problems now arising by reason of the retroactive effect of a long delayed election.

This amendment applies to taxable years beginning after December 31, 1960.

2. EFFECT OF TRANSFERRING ASSETS FROM AN ELECTING PARTNERSHIP OR PROPRIETORSHIP TO A CORPORATION

As indicated previously present law (sec. 1361) gives certain partnerships and proprietorships an election to be taxed as though they were domestic corporations. Once an election is made, the enterprise is, in general, treated as a corporation for income tax purposes.

In practice, many partnerships and proprietorships, after making the election, find it advisable to form an actual corporation to which the assets of the electing enterprise (i.e., the partnership or proprietorship) are transferred in return for all of the stock in the corporation. The present provisions of subchapter R do not expressly spell out the tax consequences that are to govern this transfer. On the contrary, they provide that an electing enterprise shall not be considered a corporation, and that the proprietors or partners of such enterprise shall not be considered as shareholders, for purposes of parts III and IV of subchapter C of chapter 1 (relating to corporate organizations and reorganizations).

Where such an electing enterprise transfers its assets to an actual corporation in exchange for its stock, a problem arises as to how to treat the transfer for income tax purposes. If the enterprise had in fact been a corporation (rather than simply being treated as one by reason of sec. 1361) the transaction would qualify as a tax-free reorganization. As such, neither the enterprise nor its owners would be required to recognize any gain arising from the exchange of the assets of the enterprise for the stock of the corporation. Further, the transferee corporation would be deemed to have stepped into the "tax shoes" of the transferor. Consequently, the various tax attributes of the transferor, such as the earnings and profits, and the basis for the assets transferred, would carry over to the transferee. This approach, however, is not applicable to an unincorporated organization electing to be treated as a corporation since the present statute (sec. 1361(m)) specifically provides that the various reorganization rules of the 1954 code are not applicable. As a result, the proposed regulations of the Treasury Department provide for a tax on this transfer.

More specifically, the proposed regulations provide that prior to the transfer the enterprise is deemed to have distributed its assets to the proprietor or partners in a liquidation and that the latter are considered subsequently to have transferred the assets to the actual corporation. This view of the transaction would require the proprietor or partners of such an enterprise to pay a tax on any gain they may have had on this assumed liquidation. The gain would be measured by the difference between the fair market value of the assets received from the enterprise and the basis (i.e., the tax cost) of their interest in the enterprise.

Prior to the issuance of the proposed regulations many proprietors or partners of unincorporated enterprises that had previously made the election under section 1361 transferred the assets of the enterprises to actual corporations in the belief that the transfers were tax free. In some cases, the proprietors or partners would have difficulty paying the tax imposed on the assumed liquidation out of their own funds and therefore may have to obtain taxable distributions from the corporation involved. As a result, a number of protests have been made to the position the Treasury has taken in the proposed regulations.

On the other hand, as a result of the inapplicability of the reorganization provisions, the transfer from an electing enterprise to an actual corporation may be treated as tax free only at the cost of creating a serious loophole, for it would mean that the electing enterprise could, by making such a transfer, eliminate free of tax any accumulated earnings or profits that may have existed immediately before the transfer.

The dilemma is that one of the two possible positions under the present statutory provisions would create a loophole by not requiring the tax attributes, including the earnings and profits, of the electing enterprise to be carried over to the actual corporation, and the other would impose an undue or at least an unexpected tax liability on the partners or proprietors of the electing enterprise if liquidation is assumed to occur prior to the transfer to the actual corporation.

In view of the above considerations your committee in section 8 of the bill amended the statute to allow the transaction described above to be treated as a tax-free reorganization. This treatment would require that the various attributes, including the earnings and profits, of the enterprise be carried over to the actual corporation and thus prevent the loophole that otherwise is possible, and at the same time avoid the imposition of any tax on any assumed liquidation by not assuming that any such liquidation took place.

This amendment is to apply with respect to taxable years beginning after December 31, 1959.

B. Technical Explanation

This section amends section 1361 of the 1954 code (relating to unincorporated business enterprises electing to be taxed as domestic corporations) by changing the rules governing the time and manner of making the section 1361 election, by conforming the provisions of section 1361(b) (relating to the qualification for election), and by repealing section 1361(m) (relating to organizations and reorganizations).

1. TIME FOR MAKING ELECTION

Section 8(a)(1) of the bill changes section 1361(a) of present law by providing new rules as to the time for making the election under section 1361.

Unlike present law which permits the election to be made "not later than 60 days after the close of the taxable year," new section 1361(a)(2) provides for the making of the election during the first month of the taxable year or during the month preceding such first month. However, in the case of a change of ownership as described in subsection (f) of section 1361, where the original electing proprietor or partners have an interest of 80 percent or less in the profits and capital of the enter-

prise, and where the election terminates because of such change of ownership in the absence of a new election, the election may be made at any time within 60 days following the date of the change of ownership. The 60-day period permitted for an election following a change in ownership described in subsection (f) may overlap the end of the taxable year in which the change in ownership occurs, so that the election may in some cases be made during the taxable year following the year to which it relates.

2. PERSONS TO MAKE THE ELECTION

Section 8(a)(1) of the bill also provides new rules as to the persons who may make the election on behalf of the unincorporated business enterprise. Under new section 1361(a)(1)(A), if the election is made on or before the first day of the taxable year with respect to which it relates, the election is to be made by the proprietor or all the partners owning an interest in such enterprise on such first day. Accordingly, if the election is filed before such first day and is executed by the then owners of the enterprise, the election will be valid only if any new owner, acquiring his interest after the election is filed and on or before such first day, joins in the election. If the new owner joins in the election but does not do so until some time following the first day of the year, then the election will be considered to have been made following the first day of the year, and the rules of subparagraph (B) will apply.

New section 1361(a)(1)(B) identifies the persons who are to make the section 1361 election where the election is made after the first day of the taxable year. In such a case all the proprietors or all the partners who have owned an interest in the enterprise at any time during the period beginning with the first day of the taxable year and up to and including the day of the election are to make the election.

The rule of subparagraph (B) applies not only to the first election by an unincorporated business enterprise but also to a new election following a change of ownership described in subsection (f). Therefore, in the case of such a change of ownership the new election will be executed by all persons who were owners of the enterprise at any time during the period beginning with the first day of the year of change and up to and including the date of the new election, whether or not the election date falls in the following taxable year.

Qualifications for election

Section 8(a)(2) of the bill amends section 1361(b) (relating to qualifications for election) to conform the same to the provisions of section 1361(a) as amended by section 8(a)(1). Under existing law the qualifications described in section 1361(b) must be satisfied at all times on or after the first day of the taxable year to which the election relates and on or before the date of election. Under section 1361(b), as amended by the bill, such qualifications must be satisfied at all times during the taxable year to which the election relates.

Repeal of section 1361(m)

Section 8(b)(1) of the bill repeals section 1361(m) (relating to organizations and reorganizations), and section 8(b)(2) of the bill makes a conforming change in section 1361(c) (relating to the applicability of the corporate provisions to certain electing unincorporated business enterprises).

As a result of the repeal of section 1361(m) an unincorporated business enterprise as to which an election has been made under section 1361(a) will be considered a corporation for purposes of parts III and IV of subchapter C of chapter 1 as well as for all other purposes of subtitle A of the Internal Revenue Code of 1954 (except chapter 2 thereof) with respect to operation, distributions, sale of an interest, and any other purpose; and each owner of an interest in such enterprise will be considered a shareholder thereof in proportion to his interest. Under present law (with certain exceptions applicable to contributions of property to a section 1361 enterprise and the organization of such an enterprise), because of the provisions of section 1361(m), an unincorporated business enterprise making the section 1361 election is not considered a corporation for purposes of parts III and IV of subchapter C.

Effective dates

Under section 8(c) of the bill the amendments made to section 1361(a) and (b) of present law are effective only for taxable years beginning after December 31, 1960. Thus, any elections with respect to prior taxable years are governed by present law. The repeal of section 1361(m) shall apply with respect to taxable years beginning after December 31, 1959.

VIII. EXCISE TAX ON MECHANICAL LIGHTERS FOR CIGARETTES, CIGARS AND PIPES (SEC. 9)

Present law imposes a tax of 10 percent of the price at which a manufacturer, producer, or importer sells mechanical lighters for cigarettes, cigars, and pipes.[1] This tax, since it is on an ad valorem basis, results in a larger tax per lighter in the case of those producing or importing relatively more expensive lighters than in the case of those producing or importing the cheaper lighters. Thus, for example, the tax payable in the case of a lighter sold by a manfucturer at a price of $5 is 50 cents, while the tax in the case of a lighter sold by a manufacturer for 50 cents is only 5 cents.

American producers, who for the most part produce the more expensive lighters, have found it increasingly difficult in recent years to compete with foreigh producers of the cheaper lighters. The severity of this competition from foreign producers is indicated by table 1, which shows the growth in imports of lighters in the past 11 years from about 460,000 in 1948 to about 46.6 million in 1959. In other words, imports in 1959 were more than 100 times those in 1948.

On the other hand, although there are no satisfactory data on the overall domestic production of lighters, there is general agreement that this production has been drastically decreased in recent years. A leading manufacturer reports, for example, that there has been a steady decline in his sales to a point where the number of units sold in 1959 were only 18 percent of the number sold in 1951. Moreover, as table 1 shows, while this occurred, imports increased nearly 64 times from 1951 to 1959.

[1] The more expensive lighters ornamented with silver or other precious metals (or imitations thereof) are subject to the 10-percent retailers tax on jewelry and related items, instead of this manufacturers' tax. No change is made by this bill in the lighters subject to this retailer tax.

TABLE 1.—*U.S. imports of cigar and cigarette lighters and parts for the years 1948 through 1959 by principal sources (those of metal other than gold or platinum, valued over 20 cents per dozen pieces)*

[In thousands of units]

	1948	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958 [1]	1959 [1]
Japan	3	31	350	610	10,209	9,134	6,742	8,627	19,608	25,092	20,213	41,792
West Germany [2]	([3])	([3])	3	28	1,835	2,414	113	549	577	579	673	905
Austria	71	([3])	22	66	733	1,306	1,916	1,527	1,922	1,235	1,406	1,612
United Kingdom [4]	10	-----	4	1	594	1,789	271	221	52	207	257	69
Switzerland [5]	231	75	2	8	7	4	5	4	4	6	8	18
All other	145	20	80	16	87	105	58	109	160	567	1,468	2,186
Total [6]	460	127	461	729	13,464	14,753	9,104	11,037	22,324	27,687	24,024	46,581

[1] Preliminary.
[2] Data for 1948–51 are for both West and East Germany.
[3] Less than 500.
[4] Includes only those with a value not over $5 per dozen.
[5] Includes only those with a value over $5 per dozen.
[6] Detail will not add to totals because of rounding.

Source: Compiled from statistics of the U.S. Department of Commerce.

Your committee is concerned because the larger tax usually payable on the generally more expensive American lighters has been a factor in this worsening of the competitive position of the American producers.

Your committee's bill mitigates the problem faced by the American producers by providing that the tax on lighters is to be a tax of 10 cents per lighter but not more than 10 percent of the manufacturer's sales price. Thus, for all lighters sold by a manufacturer for $1 or more, the tax per lighter will be 10 cents. However, for those lighters sold by manufacturers for less than $1, the tax will continue as under present law to be 10 percent of the manufacturer's sales price.

This change is made by your committee's amendment as of the first day of the first month beginning more than 10 days after the date of enactment of this amendment.

It is estimated that this provision will result in an annual revenue loss of about $400,000.

IX. MODIFICATION OF FILING REQUIREMENTS FOR DECLARATIONS OF ESTIMATED INCOME TAX BY INDIVIDUALS (SEC. 10)

Present law (sec. 6015) provides that, for an individual with no more than $100 of gross income from sources other than wages or salaries, a declaration is required if his gross income is expected to be more than $5,000; however, no declaration is required by a married person if the gross income of the married person and his spouse is expected to be not more than $10,000 (nor from a head of a household or a surviving spouse if his gross income is expected to be not more than $10,000). For an individual with more than $100 of income not subject to withholding, a declaration is required if his gross income from all sources is expected to be more than $600 per exemption plus $400.

Under these provisions, approximately 1.7 million declarations filed annually show either small liabilities or no liabilities to pay estimated tax. In 1958, out of the 5.7 million declarations filed, 1.1 million, or

one-fifth of the total, showed no estimated tax and 600,000 declarations showed small amounts of estimated tax.

Your committee believes that eliminating nontaxable declarations and reducing the number of declarations from low-income taxpayers will result in a substantial saving to both the Government and the taxpayers. Section 10 of the bill therefore amends section 6015 so that a declaration will not be required in any case in which the estimated tax liability is less than $40. It is expected that this change will substantially reduce the number of declarations filed each year.

Because of this new minimum amount for filing declarations, it is believed that the present filing requirements with respect to income not subject to withholding will become unrealistic in that many taxpayers with nonwithheld income between $100 and $200 and within the minimum amounts of income from wages subject to withholding, will ordinarily not be required to file declarations because their estimated tax liability will be less than $40. To avoid the filing of declarations by low-income taxpayers, section 10 of the bill also raises the $100 nonwithheld income limitation to $200.

To simplify the filing requirements also further, the gross income test of $400 plus $600 times the number of exemptions is eliminated. Under this change, the only test for the filing of declarations by taxpayers with income not subject to withholding will be whether or not the tax is in excess of $40. It is believed that most taxpayers who at present are not required to file a declaration because of the gross income test will continue to be exempt under the $40 limitation.

This amendment applies to declarations of estimated tax filed with respect to taxable years beginning after December 31, 1960.

X. PLACE FOR FILING TAX RETURNS (SEC. 11)

A. General Explanation

Present law (sec. 6091) provides that returns of tax by a taxpayer other than a corporation are to be filed in the internal revenue district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in any internal revenue district, then at such place as may be prescribed by regulations. This section also provides that returns of tax by a corporation are to be filed in the internal revenue district in which is located the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in any internal revenue district, then at such place as may be prescribed by regulations.

The International Operations Division of the Service was established to carry out better and more uniform enforcement of the revenue laws in the case of certain American citizens who are outside the United States, individuals and domestic corporations claiming benefits for income derived outside of the United States, nonresident aliens, and foreign corporations. This Division is handicapped in its operations because the inflexible rules of present law preclude the direct filing of returns from such persons with this Division.

Accordingly, section 11 of the bill amends present law to provide that the Secretary or his delegate may prescribe by regulations the place where the returns of these taxpayers must be filed. Specifically,

section 6091(b)(1) is amended to provide that tax returns of citizens of the United States whose principal place of abode for the taxable year is outside the United States, tax returns of individuals who claim the benefits of section 911 (relating to earned income from sources without the United States), and sections 931 and 933 (relating to income from sources within possessions of the United States), and tax returns of nonresident alien individuals shall be filed at such places as may be prescribed by regulations. Section 11 also amends section 6091(b)(2) to provide that tax returns of foreign corporations, and tax returns of domestic corporations which claim the benefits of section 922 (relating to the special deduction for Western Hemisphere trade corporations), section 931, or section 941 (relating to the special deduction for China Trade Act corporations), shall be filed at such places as may be prescribed by regulations.

Under these amendments, the Service could require "foreign" returns to be filed with the International Operations Division and thus could eliminate the present cumbersome and roundabout procedure under which certain returns are filed with the various districts and are then transferred to that Division. This would facilitate, as well as result in economies in, the processing and handling of these returns.

This amendment applies with respect to returns for periods beginning after December 31, 1959.

B. Technical Explanation

Subsection (a) of section 11 of the bill amends section 6091(b)(1) of the 1954 code (relating to the place for filing individual tax returns) to specifically provide that tax returns of individual citizens of the United States whose principal place of abode for the period with respect to which the return is filed is outside the United States, tax returns of individuals who claim the benefits of section 911 (relating to earned income from sources without the United States), section 931 (relating to income from sources within possessions of the United States), or section 933 (relating to income from sources within Puerto Rico), and tax returns of nonresident alien individuals shall be filed at such place (or places) as the Secretary or his delegate may by regulations prescribe. Under the existing law, if such individuals have a legal residence or principal place of business located within an internal revenue district, then their tax returns must be filed in such internal revenue district.

Your committee intends that an individual citizen of the United States should not be considered to have his principal place of abode for the period with respect to which the return is filed outside the United States if such individual is temporarily outside the United States due to special circumstances.

Subsection (b) of section 11 of the bill amends section 6091(b)(2) of the 1954 code (relating to the place for filing corporate tax returns) to specifically provide that tax returns of foreign corporations and tax returns of domestic corporations which claim the benefits of section 922 (relating to the special deduction for Western Hemisphere trade corporations), section 931 (relating to income from sources within possessions of the United States), or section 941 (relating to the special deduction for China Trade Act corporations) shall be filed at such place

(or places) as the Secretary or his delegate may by regulations prescribe. Under the existing law, if such corporations have a principal place of business or principal office or agency located within an internal revenue district, then their tax returns must be filed in such internal revenue district. In addition, subsection (b) deletes the phrase "or agency" wherever it appears in section 6091(b)(2). The term "agency," as used in the general rule that a corporation shall file its tax return in the internal revenue district in which is located its principal place of business or principal office or agency, relates only to foreign corporations. Since subsection (b) amends section 6091(b)(2) to specifically except foreign corporations from that general rule, the retention of the word "agency" is unnecessary.

The amendment made by section 11 of the bill is applicable with respect to all returns to which the present section 6091(b)(1) and (2) apply, including income, gift, employment, and excise tax returns.

Subsection (c) of section 11 of the bill provides that the amendments made by subsections (a) and (b) shall be applicable with respect to returns for periods beginning after December 31, 1959.

XI. CLAIMING A FALSE OR FRAUDULENT DEDUCTION FOR EXEMPTION TO BE TREATED AS A MISDEMEANOR RATHER THAN A FELONY (SEC. 12)

Present law (sec. 7201) makes it a felony for any person willfully to attempt in any manner to evade or defeat any tax imposed by the code. Section 7207, on the other hand, makes it a misdemeanor for any person willfully to deliver or disclose to the Secretary or his delegate any list, return, account, statement, or other document known by him to be fraudulent or to be false as to any material matter.

Section 7207 of the 1954 code is based, in part, upon section 3616(a) of the Internal Revenue Code of 1939, which, in turn, was ultimately derived from the Revenue Act of 1798. In *Achilli* v. *United States* (1957) 353 U.S. 373, the Supreme Court held that section 3616(a) of the 1939 code did not apply to income taxes. Although section 7207 of the 1954 code differs in some respects from section 3616(a), both the Senate Finance Committee and the House Ways and Means Committee reports relating to H.R. 8300 (which was enacted as the Internal Revenue Code of 1954) state that section 7207 "contains no material change from existing law." This statement in the committee reports results in some doubt as to whether section 7207 is applicable in income tax cases. In view of this doubt, the Government is no longer bringing prosecutions under section 7207 and does not consider that section to be a useful enforcement tool. It may be added that if section 7207 is applicable to cases involving income taxes, that section would then overlap to some extent section 7201 of the 1954 Code, which makes it a felony to attempt to evade or defeat tax. This overlap could create problems in criminal tax prosecutions. See the decisions in *Berra* v. *United States* (1956) 351 U.S. 131, and *Achilli* v. *United States, supra*.

Under section 12 of your committee's bill section 7207 is repealed.

At present, approximately 75 percent of the "small tax evasion" cases involve the claiming of a false or fraudulent deduction for exemption. In order to provide a specific penalty for this offense your committee has added a new subsection to section 7205 (relating

to fraudulent exemption certificates). This new subsection would specifically make it a misdemeanor for any individual to willfully claim in his income tax return any false or fraudulent deduction for exemption under section 151. Because of the number of such offenses and the relatively small amount of evaded tax which they involve, your committee believes the enforcement program would be improved if a misdemeanor provision, rather than a felony, were available for the prosecution of these cases. Accordingly this provision contains a penalty of not more than $500, or imprisonment for not more than 1 year, or both. This amendment is applicable to offenses committed after the date of enactment of this bill. Certain minor amendments are also made to conform other provisions of the statute to the above-described changes and to continue the present 6-year period for commencing a prosecution.

XII. CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).